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No Happy Anniversary

Just one year ago, as financial markets lost confidence in the Greek government's ability to meet its mounting debt obligations, fellow Eurozone members along with the International Monetary Fund (IMF) stepped in to provide a 110 billion euro bail-out. This prevented an immediate collapse in Greece's public sector and financial system. However tough and unpopular the last year of fiscal austerity and recession has been, it would have been far worse without the emergency loans.

Recently reported data for the first quarter of 2011 showed GDP down about five percent versus 2010, but losses may have been as much as double this figure without the assistance that has kept the government, and by implication the banking system, functioning.

However, there is not yet sufficient light at the end of the debt tunnel to boost confidence in the medicine working. Further upward revisions to Greece's debt data, as well as the difficulties that have been seen and will continue to emerge in meeting fiscal targets, have put the spotlight on the root of the problem: excessive debt.

Considerable headwinds are hampering efforts to bring debt under control. Firstly, annual interest costs alone will be as much as seven to eight percent of GDP and rising as debt is now estimated to reach around 150 percent of GDP in 2011. Thus the government will not be able to reduce the budget deficit unless it achieves a substantial surplus on the primary budget – the balance between revenues and non-interest expenditure.

Secondly, it is extremely difficult to achieve and maintain a primary budget surplus. The programme of structural adjustments, spending cuts and tax reforms agreed as part of the bail-out deal has been only partially implemented. The tax take remains low, and moves towards deregulation and

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privatisations are progressing only slowly, hindered also by recessionary conditions.

And thirdly, while government debt was expected to peak at about 150 percent of GDP, it is now likely to rise to over 160 percent of GDP even if the tough budget targets set in the bail-out deal are met, which is unlikely.

With weak local growth and low national savings, the level of debt and interest payments in Greece are simply too high to be supported. Last year's rosy image of Greece beginnning to bring debt under control and return to capital markets for funding by 2012, or even starting to repay the emergency loans by 2014, was not realistic. Talks are now in progress over extending the funding programme and modifying the terms. However, to many observers, this is becoming increasingly like a permanent bail-out or restructuring exercise, and concerns about the risk of a Greek default and/or euro exit have escalated once more.

LIMITS OF CREDIBILITY

Last year, as the Greek crisis threatened to boil over and infect other countries, the Eurozone's announcement of a sizeable bail-out plan for periphery debtors – the European Stability Mechanism (ESM), to be operated in conjunction with the IMF – was punchy enough to convince investors that there would be no disorderly defaults in the short-term. Countries at risk would be protected for the coming one to two years. It also provided a breathing space for a more thorough, long-run solution to be thrashed out. Yet, after a short respite, the situation steadily deteriorated and, one year on, even the terms of the Eurozone bail-out mechanism have yet to be fully settled. It is now much harder to persuade markets that there are no default risks and debts will be repaid in full.

It is no surprise that the periphery debt crisis continued to escalate through 2010-11. As its banking crisis overwhelmed national resources, Ireland was forced into accepting assistance at the end of 2010 – a total of 85 billion euro – at the limit of what the government could credibly take up and still claim to be solvent. This was followed in May this year by the practically inevitable bail-out for Portugal – of nearly eighty billion euro – just in time to prevent its banking system from collapsing. In addition, Greece is seeking more money over an extended period to meet its obligations and Ireland is also to receive more funding from the IMF. Bail-outs do not appear to be coming to an end.

Apart from the shifting scale of the bail-outs, their varying terms are also somewhat confusing, prompting complicated wrangles over the differing interest rates applied across the four to six percent range, and demands for adjustments to reduce the cost of loans. Negotiations over the ESM – likely to be completed at the European Summit in June – by the countries being bailed out are expected to focus on easier repayment terms and lower interest costs. However, any such subsidies will have to be provided using Eurozone funds, as the IMF has no mandate to pursue such concessions.

In theory, there is also potential for a creditor agreement on rescheduling, involving the European banks (which are the main holders of periphery debt), as well as the European Union (EU) and the European Central Bank. Nevertheless, the Eurozone may persist in declaring that any such aid would not represent a restructuring – although, effectively, it would be. Debtors would not repay all debt and interest costs in full. It is hardly surprising that creditors are less than eager to agree, in fact the ECB is also uneasy as it is now a major creditor.

WHAT WOULD BE A VIABLE LEVEL OF DEBT?

The latest surge in market interest rates on periphery sovereign debt towards twenty percent or more reflects further downgrades from the credit rating agencies and a renewed slump in investor sentiment. Access to markets is restricted and would be too costly to be supportable for the troubled periphery economies. This is not the fault of markets and speculators – the scale of debt in these countries, coupled with the difficult task of achieving both fiscal austerity and a return to growth, have damaged confidence in the ability of the respective governments to meet the terms of bail-out plans and repay debts, even under a regime of cheap emergency loans.

For debtor countries, a moratorium on all interest costs – effectively a form of staggered 'hair cut' for creditors – would probably not be sufficient to bring debt down to manageable levels by 2013, the end of the present ESM. To return to a

Poul Thomsen of the IMF, Jurgen Kroger from the European Commission, and Rasmus Ruffer of the ECB leave the Portuguese Finance Ministry.

sustainable position, some debt reduction will be necessary. Instead of trying to fudge the terms of repayments on debts that cannot be repaid, suppose the question is turned around: what level of debt might the periphery economies actually be able to afford to repay? How much would the 'hair cut', of one form or another, have to be to reach a viable level?

For example, cancellation of about a third of the present debts should leave the debt burdens of Ireland and Portugal close to a sustainable range. Fiscal austerity would still have to continue over some years to bring debt back to safer levels of around sixty to seventy percent of GDP, but this would not be impossible to achieve and would offer the prospect of a resumption of normal policymaking within a reasonable time frame.

However, for Greece, the situation is more complex. A one-third of debt cancellation would still leave debt at just over one hundred percent of GDP. Moreover, high interest payments make stabilising the debt a tough task. Reducing Greece's debt level closer to sixty to seventy percent of GDP may therefore require a combination of debt cancellation and easier interest payments – or a massive upfront 'hair cut' of fifty to sixty percent.

FRACTIOUS POLITICS

Politically, the tensions have also grown. Not only are troubled debtor countries seeing voter resentment build up over the scale of fiscal austerity and persistently weak economic conditions, but those countries providing the bail-out funds are also restive. This was perfectly illustrated by the electoral gains made by anti-bail-out parties such as the True Finns, and the loss of support for the ruling coalition in Germany. Periphery voters see themselves unfairly bearing the cost of paying back EU banks, while voters in the rest of the Eurozone are unhappy at bailing out periphery governments.

In addition, there could be trouble brewing in EU relations with the IMF, the Eurozone's bail-out partner, as its terms of engagement in financial assistance are constrained – bail-out terms must be adhered to, loans must be repaid and it cannot offer lower interest rates on the funds made available. There may also be disagreements about progress on budgets and reforms and policy options - which could become more difficult to manage given the likely departure of Strauss-Kahn as head of the IMF. If additional assistance is to be granted to debtors, then the Eurozone may find that it has to provide all of the new funding itself. This could also be a financial challenge if the cost of bail-outs continues to escalate.

A REALISTIC ENDGAME?

For the Eurozone, the imperative for all member states must be to reduce debts to sustainable levels while ensuring that reforms put economies on a sound footing to achieve future growth. But more must be done to collectively contain the risks posed by the periphery debtors. First of all, an injection of realism is necessary. Over-optimistic projections for the speed and scale of reforms and fiscal adjustment will lead to the debilitating experience of persistent failures. This is unlikely to ensure a return to capital markets for periphery governments.

Secondly, excessive debt must be recognised as uncontrollable by fiscal austerity alone. In the case of Greece, with the highest level of debt, a solution will require not only progress on raising the tax take, deregulation and privatisation receipts, but also some combination of measures to reduce debt and lower interest payments in order to bring the overall debt level down.

And thirdly, simply extending existing emergency financing arrangements, either in maturity or scale, may only make political tensions within Europe worse, reduce the incentive for debtors to get their fiscal houses in order and fail to resolve the underlying problem of excessive debt.

The reluctance of the Eurozone leadership to contemplate the 'R' word (restructuring) may be due to concern that easier terms for debt will simply encourage both a return to laxity and more requests for debt relief. But the risk of moral hazard and debt games cannot hold back a final resolution of the debt dilemma for ever. The ultimate endgame will simply be default for countries with uncontrollable debts. And the prudent parts of the Eurozone may be unable to finesse either the timing or the impacts of any default. It may be better to settle early and decisively.

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